Fraud on the market
A relational investment approach

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Abstract

Regulators of securities markets across the globe uniformly impose strict liability on firms that raise capital by means of a misleading prospectus. But regulators are divided in their approach regarding the circulation of false information in the secondary market. Indeed, on one side of the Atlantic, we find England adhering to its conservative Common Law approach and on the other side, the United States with the broad liability embodied in the “Fraud on the Market” paradigm under Rule 10b-5.

Fraud on the Market (FOMA) has been one of the most popular topics of discussion among American legal scholars over the last two decades. The focus of scholarship has been placed mainly on the effect of FOMA on the efficiency and on the fairness of the American stock market. This paper takes a different approach: it highlights and compares the effects of three liability regimes on corporate governance and, in particular, on the relational investment structure of a publicly held firm. Moreover, the paper shifts the focus of discussion from the effect of liability on a firm’s incentives to the effect of the compensatory scheme of each regime on investor conduct.

The three liability regimes this paper examines are as follows:

The traditional Common Law regime, under which plaintiffs must demonstrate proximity, reliance, and causation;

The reliance regime, under which plaintiffs are required only to demonstrate reliance and causation;

The fraud on the market regime, whereby plaintiffs prevail if they can establish causation.
The first part of this paper examines the effect of liability on monitoring. In particular, I argue that the traditional Common Law regime manifests and fosters the monitoring role institutional investors play in England. The American deviation from the traditional rule, in the form of the Fraud on the Market regime, discourages such relational investment and encourages shareholder passivity.

The second part of the paper adopts an (almost) opposite agency model: whereas the first part treats the collective body of shareholders as principals concerned with their manager-agent performance, the second part treats the manager as the principal who solicits feedback from informed investors-agents. Whereas monitors are inspecting the managers’ hidden actions, thereby diminishing the firm’s agency costs, feedback providers are actually informing managers, thereby enabling the latter to run the firm more efficiently. I show that each liability regime provides a different set of incentives to investors and, therefore, facilitates the operation of a different feedback mechanism. © 2001 Elsevier Science Inc. All rights reserved.

Part one: the effect of liability on investor monitoring

1. Introduction

In this part of the paper, I distinguish between three types of players: (1) “Monitors,” typically institutions that oversee management and take action against bad managers; (2) “Informed Traders,” whose trading decisions are based on the collection and analysis of public and private information; and (3) “Liquidity Traders,” who enter or exit the market according to their liquidity needs.\(^2\) I show that each liability regime attracts and alienates different players to and from the market. Specifically, I show that FOMA pushes monitors out of the market, and thus it can supplement Mark Roe’s list of American rules that impede shareholder activism.\(^3\) The traditional Common Law regime, on the other hand, is shown to attract monitors, and thus it promotes the type of relational investment documented by Black & Coffee in Britain.\(^4\)

In addition I show that the U.S. move from the traditional Common Law rule, first to the reliance, and thereafter, to the FOMA regime, may also have been a catalyst in the evolution of the most important monitoring device in the U.S., the hostile takeover. Whereas the Common Law regime dictates a “fair,” open-card game, Fraud on the Market (and the reliance regime) impels contestants in this market to employ tricky stratagems.

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\(^3\) Mark J. Roe, Strong Managers, Weak Owners - The Political Roots of American Corporate Finance (1994). In this book, Mark Roe convincingly showed that shareholder passivity is not necessarily an inevitable product of free market forces. Instead, he suggested, it is an outgrowth of U.S. regulations, including, *inter alia*, the ban on bank ownership of stock, limitations on size of block owned by insurers and mutual funds, and proxy rules that curb the ability of institutional investors to join forces and influence the firm.

2. The marginal effect of the traditional common law

Consider the following paradigmatic case:

Orange, a publicly traded firm, announces that it is about to complete development of a new hardware product. In response, Orange’s stock price soars. A few months later, after the public learns about the product’s technical problems and disappointing sales, Orange’s market price drops. Traders who purchased Orange’s shares at the inflated price file a suit to recover their out-of-pocket damages, claiming that Orange was or should have been aware of certain technical and marketing risks involved in the project, but failed to disclose these risks.\(^5\)

Traditionally in Anglo-American Common Law, such a suit would be dismissed for lack of proximity between the traders and the firm.\(^6\) The British House of Lords recently reaffirmed this position in the 1990 decision *Caparo v. Dickman*.\(^7\) The Lords rejected the plaintiff’s argument that holding shares in the firm or trading the firm’s shares positions the plaintiff in proximate relations with the firm. The proximity requirement is satisfied and the suit may be sustained in England only if the defendants - i.e., the firm or its agents - had actual knowledge of the plaintiff’s plan to rely on the release.\(^8\) I classify this regime of liability, which sets up a relatively strict standing barrier to litigation, as the *traditional Common Law* approach.

The traditional Common Law regime confines the firm’s liability only to investors whose reliance on the firm’s statement was known to the firm. Hence, it encourages investors considering an investment in the firm to approach the firm’s management and reveal their plans. Similarly, it encourages investors to approach management when they are considering exit. Furthermore, the channels of communication with the firm’s management are more accessible to those investors who maintain close ties with the firm. Thus, the Common Law regime can be seen as a mechanism designed to benefit institutional investors who monitor the firm’s activity on a day-by-day basis.\(^9\) Liquidity traders and anonymous informed traders,
on the other hand, are not offered any compensation, and indirectly are the ones who bear the cost of compensating the monitors. By forcing free-riders to compensate the active shareholders, the Common Law regime mitigates the collective action problem shareholders of a publicly held corporation face.10

3. The marginal effect of a reliance regime

American tort law, in most jurisdictions, still follows the traditional Common Law approach and conditions liability on proximity.11 But the U.S. federal securities law has taken a very different route. In 1946 a federal district court held that Rule 10b-5, in addition to its administrative and criminal penalties, gives rise to a private remedy.12 The Supreme Court upheld this position in 1970.13 By recognizing a private right of action under Rule 10b-5, federal courts released traders from the proximity requirement and endorsed the reliance regime.14 Many state legislatures followed suit and incorporated the reliance regime into their “Blue Sky” laws.15

A reliance regime triggers two conflicting effects. On the one hand, it accommodates traders whose trading strategies are based on the analysis of a firm’s public disclosures, as they are the ones who can demonstrate reliance. By rendering informed trading more profitable, such a reliance rule encourages informed agents to trade anonymously and to take a free ride on the monitoring efforts of their colleagues. Hence, all things being equal, more informed trading and less monitoring activity takes place in a market governed by a reliance regime than in a market governed by the traditional Common Law. Arguably, therefore, the

10 Perceiving the Caparo v. Dickman rule as a mechanism designed to promote relational investment provokes inquiry into the operation of this mechanism - an inquiry that has yet to reach the courts. For example, it is not clear whether firms are allowed to restrict their litigation risk by artificially raising the cost of communication between investors and the firm.

11 For a review of American law on negligent misrepresentation, see Restatement 2d on Torts, §552.


14 In fact, Congress explicitly endorsed the reliance regime already in 1934 when it adopted Section 18 of the 1934 Act. Courts were not at all perturbed by the fact that the ramifications of a private right of action under Rule 10b-5 is that it preempts Section 18 and circumvents the procedural constraints Congress introduced in an attempt to restrain such suits. The most important constraint Congress imposed on Section 18 right of action was that it only covers documents that were filed with the SEC pursuant to the Act. Hence, voluntary disclosures that were not mandated by law, and thus were not contained in a filed document, are not actionable under Section 18. But federal courts could “conceive of no rational purpose which would be furthered by creating a structure where liability for material misrepresentations adversely affecting investors would vary tremendously depending upon whether the statement happened to be filed with the SEC.” See Wachovia Bank & Trust Co. v. National Student Marketing Corp., 650 F.2d 342 (D.C. Cir. 1980).

15 California is illustrative: in 1968 the California legislature adopted the California Corporate Securities Law. Under section 25500 of this Act, a trader who can demonstrate reliance on the defendant’s negligent misstatement will prevail even if no proximate relations were can be established. See Mirkin v. Wasserman, 23 Cal.Rptr.2d 101 (Cal. 1993) at p. 114.
reliance regime reduces the level of direct monitoring but facilitates market disciplinary mechanisms.16

But a reliance regime may also operate against informed traders. To understand this countereffect, we must first recognize the adverse impact of a reliance regime on liquidity traders. Liquidity traders typically do not base their trades on information and, therefore, are less likely to be able to demonstrate reliance. Liquidity traders, therefore, just like monitors are forced to bear the costs of insuring the informed traders. Hence, we may expect that a reliance regime will reduce the number of liquidity traders in the market. This adverse effect on liquidity triggers a boomerang effect against informed traders who usually profit at the expense of liquidity traders.17 Thus, the less liquidity traders play the market, the lower the ability of informed investors to take advantage of the information they accumulate. In fact, the adverse effect on liquidity may even encourage informed investors to take an active monitoring role. The overall effect of a reliance regime on monitoring, therefore, remains unclear.

4. The marginal effect of Fraud on the Market

The next endeavor of American federal courts was to do away with the reliance threshold. To begin with, federal courts stated that reliance is not a prerequisite in a non-disclosure case,18 i.e., a case in which the plaintiff’s underlying claim is not that the defendant communicated misleading information, but, rather, that the defendant kept silent, failing to unveil a material fact whose disclosure is mandated by law. The final nail in the coffin for the reliance requirement was the Supreme Court’s adoption of the “Fraud on the Market” theory.19 Under this theory, traders who bought (sold) shares at the market price can regain their out-of-pocket losses from the firm and its agents who inflated (deflated) the market by means of a misleading statement. Such traders have standing to bring a suit under Rule 10b-5 even if they cannot demonstrate their awareness of, not to mention their actual reliance upon, the firm’s statement.

Fraud on the Market has turned Rule 10b-5 into an impartial mechanism. Every trader, regardless of the role she plays in the market, can bring a suit to cover her losses resulting from a public misstatement.20 The primary practical effect of the transition to the Fraud on...
the Market regime was that it enabled a trader to bring a class action on behalf of all similarly situated traders who suffered a loss as a result of the misstatement.

Despite its egalitarian facade, Rule 10b-5’s wholesale liability regime can be viewed as an implicit subsidy to liquidity traders. The marginal effect of FOMA is to encourage investors to hold a more diversified portfolio with a smaller investment in each firm. Such a diversification strategy enables investors to increase their turnover and, thereby, increase the likelihood of benefiting from Rule 10b-5’s insurance scheme. The larger the block of shares held by an investor in a firm, the higher the investor’s costs of changing a position in the market, and consequently, the lower the investor’s volume of trade. Therefore, monitors, who must hold a large enough block to justify their costs and efforts, can rarely take a bite from the pie of damages paid by the firm.

Moreover, the larger the number of liquidity traders playing the market, the more liquid the market, and the cheaper the trade.\textsuperscript{21} As Professor Coffee insightfully reminded us, “exit” and control are substitutes: the cheaper the exit, the less likely investors are to voice their views, and vice versa.\textsuperscript{22} Hence, informed players, in a position to choose between taking a stand or exiting, will, under a FOMA regime, tend to prefer the exit option.\textsuperscript{23} We may conclude, therefore, that FOMA exacerbates the free riding problem monitors face. Thus it pushes monitors away from the market and attracts informed and liquidity traders.

5. Fraud on the Market for corporate control

Both in the U.S. and in England, the market for corporate control is considered the most effective monitoring device. Yet, the battle for corporate control in the U.S. takes a very different shape from that waged in the British market. As shown below, the differing liability regimes may offer one explanation for this disparity.

The traditional Common Law rule provides a cause of action exclusively to raiders who are indifferent with regard to dividends they should be indifferent to whether the firm pays damages to everyone or pays no one. Such a regime may be interesting to analyze in the context of the conflict of interests between creditors and shareholders, but this conflict is beyond the scope of this paper.

\textsuperscript{21} Rule 10b-5 enhances liquidity in two important ways. First, as suggested in the text, the partial insurance it provides to liquidity traders increases the number of liquidity traders and the volume of trade. The more popular explanation for the contribution of Rule 10b-5 to liquidity, however, is that the threat on publicly-traded firms increases the credibility of the firm’s public statements, diminishes information asymmetries, narrows the bid-ask spread, and, thereby, facilitates a more liquid market. Opponents of Rule 10b-5 question this result. Arguably, the market provides sufficient incentives to refrain from distributing false statements. Moreover, since Rule 10b-5 imposes similar sanctions on mandated disclosures and on voluntary statements, such sanctions actually harm market efficiency, as they diminish the agent’s motivation to share information with the public.


\textsuperscript{23} Note that my claim that the Fraud on the Market regime discourages personal contact between firms and institutional investors has no clear normative implications. I do not argue that this effect of FOMA is necessarily detrimental. To be sure, informed trading facilitates the operation of a different, arguably more efficient, monitoring device that relies on the deflating effect of informed traders’ exit.
inform the firm’s management of their reliance on the firm’s public statements. Hence, it encourages raiders to approach the target’s management at an early stage in their inquiry into the firm’s business and to reveal their plans to make a bid. This “fair play” climate which Caparo v. Dickman cultivates, is fostered by the City Take Over Code as well: on the one hand, the Code obligates the bidder, before making the tender offer public, to present the offer and its terms to the target’s board of directors; on the other hand, it denounces use of any anti-takeover defense against an identified bidder.

The U.S. law on securities fraud engenders a very different environment for the battle over corporate control. Both the reliance and the FOMA regimes provide a warranty to anonymous raiders, enabling them to keep their interest in the firm confidential for a longer period of time and to quietly acquire a significant block of shares in the firm, relying on the firm’s public statements. Consequently, American law subjects the incumbent management of an American firm to the constant threat of a hostile bid. Arguably, therefore, the departure from the Common Law regime and the move to the reliance and the FOMA regimes may have been conducive to the explosion of hostile takeovers witnessed in the U.S. during the 1970s and 1980s. In this sense, the American liability regime supports the disciplinary role of the market for corporate control.

But federal securities law does not operate in a vacuum. The constant threat of hostile takeovers, which was facilitated by federal courts’ broad reading of Rule 10b-5, received an instant response: state legislatures relaxed managers’ fiduciary duties, and corporate articles were amended to equip managers with effective shields against black knights. Such a response should have been anticipated: if FOMA were to interrupt the prevailing (optimal?) balance between managers’ interest in job security and shareholders’ interest in discipline, we could expect firms to find ways to rebalance. Arguably, therefore, to the extent that Rule 10b-5’s case law has elevated the severity of the hostile threat, it has also advanced the adoption of poison pills and the legalization of greenmail agreements. Hence, it is not at all clear whether, on the whole, Fraud on the Market has facilitated a more efficient market for corporate control.

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24 Take-Over Code, Rule 5.4.
26 For raiders it is relatively easy to prove reliance, and hence the distinction between Fraud on the Market and reliance, from their perspective, is negligible. Arguably, however, the Fraud on the Market regime increases the credibility of the firm’s statements and, thus, may even further increase raiders’ profits.
27 See M. A. Eisenberg, “Corporate Law and Social Norms” 99 Colum. L. Rev. 1253 (1999), arguing that the social norm until the mid-1970s was strongly opposed to hostile takeovers and that this norm has changed after a few hostile bids were carried by reputed firms. Arguably, as suggested in the text above, the move to the reliance regime in the 70s, and to FOMA in the 80s, may provide one explanation to this social change.
28 The American dual system leads to a perplexing legal regime. State corporate law permits the target’s board to employ a costly defensive tactic that deprives the firm’s shareholders of their right to tender their shares at a premium. Federal securities laws, on the other hand, prevent firms from reaching a similar result by precluding liability from potential bidders, even though such a tactic might be cheaper than the defense it is allowed to adopt. Norman Poser pointed out this dichotomy and suggested, citing Cicero, that it may rest on an ethical approach that has greater contempt for a wrongdoing by deception than a wrongdoing by force. See N. Poser, “Stock Market Manipulation and Corporate Control Transactions” 40 U. Miami L. Rev. 671, 686.
6. An interim conclusion

From the discussion thus far we may conclude that the regulation of fraud provides an additional vehicle for market planners to alter the mix of investor types in the market and to shape the relationship between investors and firms and between raiders and incumbents. Obviously, the proportionate mix of investor types and their relationship with the firm is affected by several other rules and institutions that prevail in each market and by the history and culture of the society within which each market operates. Regardless of the given market structure, however, a regulator can still modify the market amalgam by adopting one of these three rules. In particular, I have shown that by endorsing the FOMA regime, U.S. federal courts have rendered the stock market more attractive for liquidity and informed traders and more hostile for monitors.

Arguably, in the landmark Dirks decision, the U.S. Supreme Court has tried to mitigate the adverse effect of FOMA on monitors by adopting a relatively liberal approach to insider trading. According to Dirks, as long as a fiduciary duty has not been breached, the firm and its agents are free to leak non-public information selectively. Thus, Dirks enables firms to compensate analysts and monitors for their efforts by providing them with exclusive access to non-public information. But Dirks begs the following question: if firms are allowed to favor their monitors by tipping them with private information, why are they not allowed to employ a less discriminatory mechanism whereby the information is made public but the warranty attached to the disclosure is afforded exclusively to monitors? Shareholders may prefer the latter discriminatory mechanism because under Dirks, in order to ensure that their private line of communication with the firm’s insiders is not disconnected, institutional investors are forced to cooperate with, rather than discipline, the incumbent management. Under the traditional Common Law regime, on the other hand, monitors are less dependent on the firm’s discretion.

Part two: the effect of liability rules on firm-investor communication

1. Introduction

A common convention in the legal and finance literature is that firms distribute information for the purpose of expediting a more liquid market for their shares, thereby reducing

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30 This puzzle is especially striking in light of the fact that both Fraud on the Market and the rule against insider trading were introduced into American law by the courts’ innovative reading of Rule 10b-5. Under Dirks it seems that so long as managers do not breach their fiduciary duties, the firm is allowed provide analysts with exclusive access to non-public information. Under Basic v. Levinson, on the other hand, even if no breach of fiduciary duty is involved, the firm is not allowed to make the information available to the public and, at the same time, assume liability on an unequal basis.

their cost of capital. This premise provides a strong explanation for why firms voluntarily distribute information. It also provides a powerful justification for the Fraud on the Market regime. Absent such liability, so goes the argument, a firm’s disclosure would not be credible, would not contribute to market liquidity, and, thus, would not reduce the firm’s cost of capital.31

Critics of Fraud on the Market typically do not dispute the claim that firms distribute information for the purpose of facilitating market efficiency. Nor do they dispute the interest of firms in the credibility of their statements. Their main argument against the American liability regime is that market disciplinary mechanisms provide sufficient support for a firm’s credibility. According to this view, firms do not attach a warranty to their statements because they find the costs of legal liability higher than its marginal contribution to the firm’s credibility. For the same reason, goes the argument, there is no need to impose mandatory sanctions on voluntary misstatements.

This paper takes a different viewpoint. I am challenging the very basic premise—apparently shared by both sides of the debate—that the only reasonable goal for a firm’s public statement is to expedite a more efficient market for its shares. I suggest that firms circulate information for other purposes as well and that it is not at all clear whether credibility is a factor in the achievement of these goals.32 For example, one insightful theory for voluntary disclosure is that managers distribute earnings forecasts in order to enable the market to judge their clairvoyance.33 Managers who can better predict the firm’s performance are perceived by the market as more capable of running the firm’s business. Under this theory, therefore, managers have no interest in the credibility of their forward-looking statements at the time when they are distributed. Managers are not interested in informing the market or in inducing reliance on their statements. All they are interested in is that their forecasts be recorded and judged in the future, i.e., when the firm’s audited financial statements are released. According to this view, any liability regime, and the American

32 Debates on Fraud on the Market are often – sometimes implicitly – grounded in different attitudes with regard to the interest firms may have in the credibility of their public statements; Macey & Miller, for example, have suggested that firms may have a legitimate interest in communicating false information. See J. R. Macey & G. P. Miller, “Good Finance, Bad Economics - An Analysis of the Fraud on the Market Theory” 42 Stanford L. Rev. 1059 (1990). Basic v. Levinson is illustrative: a “no comment” response to analysts’ inquiries would have immediately uncovered the merger negotiations. Denial of the rumors served the firm’s interest in conducting the negotiations out of public sight. Hence, suggest Macey & Miller, such wealth-maximizing lies should be allowed. In reply, Ian Ayres, ibid, argued that such a “white lie” would serve the interests of the firm only if the market were to assign credibility to the firm’s statement. Ayres suggests that firms would attach a warranty to any genuine statement they circulated, and therefore, the falsity of any such “white lie” would be exposed – unless it were also accompanied by a warranty. Ayres’ separating equilibrium prevails, however, only if firms are indeed interested in the credibility of most of their public statements. Otherwise, genuine statements will not be supported by a warranty, and the market will not be able to distinguish between genuine statements and white lies. On the other hand, Macey & Miller’s contention that a denial is more effective than a “no comment” response implicitly assumes that firms are not interested in the credibility of most of their public statements and consequently that a pooling equilibrium will prevail.

regime in particular, is not only redundant but it actually increases the costs of employing this signaling mechanism.

An alternative rationale for voluntary speech focuses on insiders’ liquidity needs. Insider trading laws prohibit insiders from trading for as long as material information in their possession is withheld from the public eye. The release of such information, therefore, increases the liquidity of insiders’ investments in the firm. Again, according to this rationale, a firm does have an interest in the veracity of the information it circulates – a fraudulent statement would only further reduce insiders’ liquidity – but it has no interest in the credibility of its public statements.34

A third and very different explanation for voluntary disclosure is that it may serve a firm’s desire to impede competition. Information about a firm’s large capacity, for example, reveals the firm’s ability to dump the market. Releasing such information, therefore, deters potential competitors from entering the market for the firm’s product. Although broad liability clearly serves the interests of monopolies in the credibility of such anti-competitive statements vis-à-vis competitors, it seems clear that the intention of the promulgators of Rule 10b-5 was not to assist firms in raising entry barriers in their product market.35

This short list of possible rationales for corporate speech demonstrates the obvious: that liability for misrepresentation must be based on a theory that explains why firms distribute information. The rationale for corporate voluntary speech I submit in this paper involves relational investment. I argue that firms may communicate with the market for the purpose of soliciting feedback. The remainder of this chapter elaborates on the feedback mechanism and examines the effect of liability on its operation.

2. The feedback explanation for voluntary speech

People communicate information to others for two main purposes: one, to inform the other party, and the other, to solicit feedback from the other party. To illustrate this distinction, let us think about the reasons a law and economics scholar may have for presenting a paper in a workshop: one reason may be the interest of the scholar in promoting the novel ideas her paper invokes. But she may also find a more compelling reason for hitting the road: she may

34 Note, however, that proponents of mandatory prohibition of insider trading would typically argue that sanctions for voluntary speech should be mandatory as well. Otherwise, firms will distribute information with no warranty, the market will discount the information, and the insiders will be able to take advantage of their private information concerning the veracity of the information.

35 For a different third-party effect of corporate disclosure see M. Kahan, “Games, Lies and Securities Fraud” 67 N.Y.U. L. Rev. 750 (1992). Kahan suggests that some disclosures are not intended to communicate information to the market, but, rather, to make credible commitments vis-à-vis third parties, thereby improving the firm’s bargaining power. For example, a publicly-traded firm negotiates a deal to buy an asset. The seller’s reservation price is $100. The firm’s reservation price is $120. By making a public announcement that it will not pay more than $101 and by exposing itself to a legal sanction of more than $20, the firm alters its threatening point and improves its position in the negotiations with the seller. Under this theory, therefore, Rule 10b-5 does serve the interests of the firm; but as Kahan claims, it is probably not a socially desirable rule.
hop[e the sophisticated audience will provide insightful contributions to the paper. Even if not sophisticated, workshop participants may comprise a representative sample of the universe of potential readers (or referees) so that gathering information about their concerns is beneficial. The more ideas and concerns the paper incorporates and addresses, the better the paper, and the higher the prospects of the paper’s publication.

Firms may often act like L&E scholars and circulate information in order to solicit feedback. Market price reaction, analysts’ reports, sophisticated investors, potential retailers or end-users of the product, etc., are all sources of information from which the firm may wish to draw responses. When the firm circulates information, it expects these sources to respond and reveal information with which the firm is unfamiliar. Unlike workshop participants, however, market actors are not expected to furnish feedback simply out of collegial good will, and thus the question of incentives arises, namely, how different liability regimes affect informed parties’ incentives to share their information with the firm.

Monitors and feedback sources share one thing in common: both are outsiders who contribute to the firm’s performance. But these two mechanisms are actually grounded in diametrically opposed rationales. Monitoring is viewed as necessary for supervising the hidden actions of managers. The underlying assumption of the feedback story, however, is that some outsiders are more informed than the firm’s management, at least with regard to certain categories of information. Recalling the paradigmatic example of Orange, the firm may be able to judge the quality of its forthcoming hardware product better than the market can. But outsiders are sometimes more informed about the expected demand for the firm’s product and about similar products developed by rival firms. Hence, a public statement concerning the development of a new product may trigger several forms of feedback about the marketability of the product: stock market columnists and analysts may respond by recommending to their readers or clients that they purchase or sell the firm’s stock. Potential retailers of the product, who trust its marketability, might express interest in contracting with the firm. Consumer reports may reflect end-user preferences. And finally, market price could react positively or negatively according to traders’ assessments of the prospects of the new product.

Arguably, a firm can approach these sources of information directly and retain their consulting services, thereby gaining access to their database. But even ignoring transaction costs and expert fees, there are certain advantages to the indirect feedback-mechanism that is triggered by a public statement. First, the firm typically is not acquainted with all the relevant sources of information. One advantage of a public statement is that it enables the firm to communicate with, and solicit feedback from, the whole universe of opinions and potential sources of information. Moreover, the indirect response of analysts and consumer reports who make their opinion public is, often, more credible than the confidential response of a hired agent who risks his reputation only vis-à-vis the firm.

Most importantly, whereas retained experts risk only their reputation, market price response is generated by agents who put their money where their mouth is. When the firm

36 Indeed, in the Apple case, supra n. 4, analysts responded promptly to Apple’s release and expressed their doubts about the firm’s optimism.
raises money for a certain project, it receives a credible response from financiers who provide, or refuse to provide, the capital needed for the project. No such credible signal is transmitted when the firm uses its own revenues to finance a project. In such a case, the market price may serve as a surrogate signal. Such a market response can be achieved most effectively by making the information available to the public at large.

We may conclude, therefore, that one motive for voluntary disclosure might be the firm’s interest in soliciting feedback. The fact that a public statement injects information into the market is only a by-product – it is not the objective of the firm. Our next inquiry will be into the effect of the three liability regimes on the feedback mechanism.

3. The effect of the Fraud on the Market on feedback

The Fraud on the Market regime enhances the credibility of a firm’s statement, and therefore, prima facie, it encourages people to respond. In particular, our basic intuition would suggest that FOMA facilitates a more accurate market price response from which the firm can extract more information. The purpose of this section is to examine this intuition. First I analyze the effect of sanctions on a firm’s motivation to activate the feedback mechanism; I then move to the main inquiry, where I examine the FOMA effect on investors’ incentive to furnish feedback.

3.1 The effect of FOMA on the firm’s incentives

Critics of the Fraud on the Market regime often argue that the class action threat suppresses a firm’s motivation to distribute information. This argument is even more critical when one considers the adverse effect of FOMA on a firm’s incentive to solicit feedback from the market. Clearly, a firm would wish to solicit feedback only when it has no confidence in the accuracy of the information in its possession. A firm would not solicit feedback about the marketability of its product where it trusts the veracity of its sales prediction. Absent such confidence, the threat of a Rule 10b-5 class action may be too costly, and the firm would likely prefer to search for feedback from other sources and out of public sight.37

Arguably, the firm could escape liability by keeping its sales prediction confidential and releasing only the qualities or the intrinsic characteristics of its new product. Such an announcement may be sufficient to attract feedback on the marketability of the product. This tactic, however, may encounter three obstacles. To begin with, Rule 10b-5 case law dictates

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37 This argument may suggest an alternative justification for the dismissal of the class action against Apple Computers, supra n. 5. The court’s dismissal was based on the argument that an analyst’s column supplied the information that was missing in Apple’s release. The feedback theory may suggest that it should be dismissed because it is in the firm’s interest to enable Apple’s management to solicit feedback by making such incomplete disclosures.
that a disclosure of one fact may trigger a duty to reveal another fact. Hence, even if *a priori*, the firm is not bound to reveal any information concerning its R&D, a voluntary disclosure concerning the development of a new product may trigger a duty to disclose more information about the product. In our example, revealing the fact that the firm is developing a product X with quality Y may trigger a duty to disclose any concern the firm may have about the marketability of this product.

Releasing information about the qualities of the product may be risky even if we ignore this triggering effect. Firms would like to solicit feedback as early in the R&D cycle as possible. The earlier the feedback arrives, the more effectively the firm can take advantage of the information and alter its plans accordingly. But herein lies the second obstacle: the earlier the firm makes such a release, the more likely that the information about the characteristics of the product will turn out to be inaccurate.

The third obstacle is that FOMA might actually increase the costs of acting on the feedback. The extreme case is where the feedback convinces the firm to forego the development of the product. Such a setback exposes the firm to the risk of being sued for falsely announcing the development of the product.

We may conclude, therefore, that FOMA increases the cost of soliciting feedback from the market. However, at the same time, FOMA may still encourage market participants to respond to the firm’s release, and the benefits the firm derives from such response might outweigh the costs. The next section addresses these questions.

3.2 The effect of FOMA on investors

The FOMA regime generates two effects: it enhances the credibility of a firm’s statement and it compensates traders for losses resulting from false statements. Both of these effects – enhanced credibility and compensation – stimulate investor reliance: the class action threat encourages investors to trust the veracity of the firm’s statement; compensation allows investors to rely on the firm’s statement, whether or not it is trustworthy, because they are insured against losses resulting from false statements. In this section I investigate how these two effects influence investors’ zeal to search for information and to act upon it.

As a first step, it should be clear that to the extent that the FOMA warranty induces reliance, it also reduces a trader’s incentive to search for information about the accuracy of a firm’s statement. Thus, if a firm wants to solicit a knowledgeable feedback about demand for its product, it should not provide a warranty on its demand forecast. Insurance against

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38 See, for example, Backman v. Polaroid Corp., 910 F.2d 10, 22 (1st Cir. 1990) (“... if Polaroid failed to reveal in the Report information necessary to make other statements not misleading, such conduct would trigger a duty to disclose.”).

39 One implication of the feedback theory, therefore, is that it casts doubt on the desirability of this triggering effect of Rule 10b-5.

40 See also P. Mahoney, “Precaution Costs and the Law of Fraud on the Market in Impersonal Markets” 78 Va. L. Rev. 623 (1992). The analysis in this chapter resembles Mahoney’s approach in the sense that it concentrates on the effect of Rule 10b-5’s compensation scheme on traders’ search. Yet, while Mahoney treats any investor search as a waste, this paper’s underlying claim is that sometimes investor search may be efficient.
losses resulting from misleading forecasts reduces the marginal rent an informed person can
derive and, therefore, discourages efforts to verify the firm’s forecast.41 Similarly, the more
credible the information the firm distributes, the less the investor’s incentive to check up on it.42

A more complicated question is whether attaching a warranty to a statement concerning
one characteristic of a product, e.g., quality, would encourage investors to search for
information regarding another characteristic, e.g., marketability. The answer to this question
seems to depend on the relationship between the information the firm distributes and the
feedback the firm solicits. In cases where the feedback the firm solicits is valuable notwith-
standing the inaccuracy of the firm’s statement, it seems that the firm’s credibility is
irrelevant. For example, suppose the firm announces that it is developing an electric car of
average quality and expects the feedback to provide information about anticipated demand
for the product. Clearly, if the quality turns out to be better (or worse) than average, demand
will be higher (or lower) than anticipated. But demand may also be a function of other
factors, such as oil prices, customers’ environmental awareness, and so forth. Such inform-
ation is valuable to the firm and for the trader regardless of the car’s actual quality. In this
type of cases, therefore, even if FOMA supports the credibility of the firm’s quality
statement, it does not affect traders’ search for information about demand.

The diametrically opposed, more interesting case is when the information the firm
discloses and the information the firm solicits are complementary goods, i.e., when the value
of the feedback the firm solicits is contingent upon the accuracy of the information the firm
provides. To illustrate: even if information about demand is useful notwithstanding the

41 A numerical example may be helpful here. A publicly traded firm announces that it has developed a new
product with quality X. The market assigns a 50% probability to the statement being true, in which case the firm’s
stock value is $20, and 50% that it is false, in which case share price is expected to drop to $10. Hence at this
point, i.e., before the market is notified as to whether the statement is true or false, the firm’s shares are traded
at $15. If we were to assume that the game allows players to trade with one share only, a player would be willing
to invest up to $5 in research (only if she is assured that she will be the first to discover whether the statement
is true or false). Now assume that the law provides traders with a cause of action for erroneous statements. It can
easily be shown, assuming risk neutrality, that the market will clear at $16.66 - only at this price would
uninformed sellers and uninformed purchasers anticipate the same expected reward of $1.66 per share (including
the purchaser’s compensation in the event that the information is false). Private information about the falsity of
the statement will enable the informed party to make $6.66 by shorting a share; and the first to recognize that the
statement is correct will make $3.33 per share. Hence, the expected reward for private information is again $5,
but the expected marginal reward for private information is only $3.33. Thus, players in this game would be
willing to invest up to $3.33 in order to be the first to discover the truth. We may conclude that a full warranty
reduces the rent of private information from $5 to $3.33 per share.

42 In the above example I have ignored the effect of the warranty on credibility. Assume, for example, that
with a warranty, the statement’s credibility increases from 50% to 66%. In this case, the market will clear at $18
– only at this price would buyers and sellers have the same expected payoff of $1.33. A party who is considering
whether to search for information makes the following calculation: there is a probability of 66% that she will find
the statement truthful, in which case she will be able to buy a share and earn $2. There is a probability of 33%
that she will find the statement false, in which case she will sell a share short and earn $8. The expected payoff
for an informed person is, therefore, $4. The expected marginal rent, therefore, is only $2.66. Hence, the enhanced
credibility reduces the investor’s willingness to invest in research by $0.66.
uncertainty with regard to the car’s quality, its significance to the firm’s value is clearly contingent on whether or not the firm would actually produce the car. Hence, the more credible the firm’s release, the more an investor will be willing to search for information about anticipated demand and to trade upon this information.

We may conclude, therefore, that to the extent that the class action threat enhances the firm’s credibility, it may also facilitate feedback.\[^{43}\] The effect of FOMA’s *insurance scheme* on investor search is less straightforward. As a matter of first impression it seems that investors’ incentives to gather information and trade upon it are independent of FOMA’s remedies. The intuition behind this argument is that the FOMA regime provides compensation to any trader, informed or not. Consequently, its marginal effect on a trader’s incentive to become informed must be nil. This intuition, however, might be misleading as it ignores the distinction between the definition of informed traders in Part One of the paper and its definition here. When we dealt with the market’s disciplinary functions, we referred to informed traders as traders who follow the firm’s public statements; these traders are operating the invisible hand of the semi-strong efficient market, thereby facilitating the market’s disciplinary functions. In Part Two we refer to traders with *private* information – the information the firm solicits. These traders are better informed than the market and, therefore, are likely to purchase (or sell) more shares than other traders. Hence, they are likely to benefit from the warranty the FOMA regime provides more than the uninformed traders do.

4. The effect of the reliance regime on feedback

The firm could improve the feedback it receives by confining its warranty solely to agents who provide the feedback. A narrow, targeted liability regime of this sort would provide stronger incentives to provide the feedback and, at the same time, reduce the firm’s cost of employing the feedback mechanism.

Arguably, the reliance regime provides such a discriminatory mechanism. But to be effective, the reliance regime must be construed narrowly so that it will only benefit traders who were in possession of private information. For example, if mere awareness of the firm’s misstatement at the time of trade constitutes reliance, then those in possession of private information would have no better standing than other traders who just follow the news. Such a broad perception of reliance encourages traders to follow the firm’s disclosures and might facilitate the market’s disciplinary functions, but it would not motivate investors to search for the information the firm solicits.

To facilitate feedback the reliance regime must require “proof that a particular misstate-\[^{43}\] Note, however, that the effect of FOMA on credibility, in our context, seems relatively minor. Assuming the market knows that the firm circulates information for the purpose of soliciting feedback, the market must also know it is in the firm’s best interest to furnish true statements – the more accurate the information the firm distributes, the more precise and useful the feedback it receives.
ment or omission induced the plaintiffs to enter into the particular transaction.”\textsuperscript{44} Under this definition of reliance, it seems traders who were merely in possession of publicly-available information and had no reason to believe the market price does not reflect this information would find it hard to demonstrate reliance. Only traders who were in possession of private information or whose opinions were based on some peculiar expertise that enables them to judge the firm’s statement better than the market would be able to pass the reliance threshold. These are, indeed, the traders the firm would like to encourage to trade, as they are the feedback providers.

4. The traditional Common Law: a relational feedback mechanism

Thus far, I have examined the effect of liability on one type of feedback: the market price signal. I have demonstrated the positive and the negative effects of FOMA and of the reliance regime on this mechanism. But in fact, even if FOMA improves the market price signal, this signal is often incomprehensible, and firms may experience difficulties in its decoding. For example, a negative market response might, indeed, be attributed to the market’s assessment that demand will be lower than expected, in which case, the firm should reconsider its investment in the project. But it may also reflect the market’s prediction that a competing product is scheduled to reach the shelves earlier than expected, in which case, the firm’s best strategy may be to increase its investment in the project and expedite the R&D process. Furthermore, traders who are privy to information concerning consumers’ preferences may be optimistic about the prospects of a new product, and at the same time, other traders, with access to information about competing products or labor costs, may be pessimistic. Such conflicting assessments may create a wash that may be difficult to decode. The firm may wish to devise a more informative feedback apparatus.

The feedback mechanism could be much more informative if firms were able to uncover trader identity. Retailers may be better informed about customers’ preferences; venture capitalists may be in possession of private information concerning products developed by competing firms in which they invest; manufacturers of similar products may be better placed to assess cost of production, raw materials, and labor. A trading signal from each player, therefore, may convey a very different message.\textsuperscript{45} The combination of signals – market price and traders’ identity – may provide the firm with more information about the product than market price alone.

The traditional Common Law regime encourages informed investors to come forward and reveal their trading plans, thereby gaining a warranty on the information the firm distributes. By exposing their trading plans, these investors signal their private information.\textsuperscript{46} For

\textsuperscript{44} Carlton v. Franklin, 1990 U.S. App. Lexis 12946.

\textsuperscript{45} Of course, once acquainted with a trader’s identity, the firm may even attempt to approach the trader and solicit more explicit feedback.

\textsuperscript{46} Under current federal law, holders of more than 5% of a firm’s shares must report their trades to the SEC. The traditional Common Law rule operates differently. First, it is not conditioned on any formal threshold.
example, the fact that following the firm’s release, a retailer of similar products purchases a large block of shares reveals the retailer’s estimation that demand for the new product will be high. This feedback mechanism resembles, or perhaps mirrors, the signaling role of insider trading reports.47 Just as outsiders learn from these reports about insiders’ private information, so can managers learn from outsiders’ trading patterns about the private information in their possession.

Summary

This paper has stressed the way in which regulation of fraud can shape corporate governance of publicly traded firms. The general proposition of this paper is that each liability regime promotes a different type of relationship between firms and investors. This general proposition consists of two parts that now can be consolidated:

A firm’s public statement can sometimes be understood as a cry for help that hopefully will reach players with expertise in the firm’s enterprise. In the first part of the paper these experts responded by disciplining management, and in the second part, by cooperating and sharing their information with management. Typically, management would volunteer statements that attract ‘cooperators’ whose feedback may assist management in running the firm. Regulators, on the other hand, tend to mandate the release of information that attracts monitors.48 In both cases, however, the choice of liability regime affects the medium these experts use to respond to this cry: the traditional Common Law regime encourages investors to approach the firm’s management directly and reveal their concerns and/or private information. Thus, it fosters close and direct relationship between managers and investors. Fraud on the Market, on the other hand, encourages investors to utilize the indirect medium of the market.

Second, it is optional and not mandatory. Third, and most importantly, it encourages investors to reveal their trades to the firm and not necessarily to the whole market.